UT 96-10
Tax Type: USE TAX
Issue: Commerce Clause (U.S. Const.) Controversy
Use Tax Liability On Purchases (Non-Filer) 1981 Limit.

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS

THE DEPARTMENT OF REVENUE	)	
OF THE STATE OF ILLINOIS	)	
	)	**No.**
v.	)	**No.**
	)	**IBT Nos.**
TAXPAYER	)	
	)	**Charles E. McClellan**
Taxpayers	)	**Administrative Law Judge**

RECOMMENDATION FOR DISPOSITION

APPEARANCES: John D. Alshuler, Special Assistant Attorney General, for the Department of Revenue; Garland H. Allen and Scott J. Heyman, Hopkins & Sutter, for TAXPAYER and TAXPAYER

Synopsis:

This matter comes on for hearing pursuant to the taxpayers' timely protest of Notice of Liability XXXXX dated January 29, 1992, issued to TAXPAYER, and Notice of Liability XXXXX dated February 6, 1992, issued to TAXPAYER by the Department for Retailers' Occupation Tax ("ROT") and Use Tax. The parties stipulated that the following questions are at issue:

1. How to determine the Use Tax base of equipment owned by an out-of-state lessor and leased for use in Illinois and other states.

2. Whether the taxpayers are entitled, under 35 ILCS 105/3-55 to a credit against Illinois Use Tax liabilities for sales and use taxes paid to other states with respect to rental equipment after the date such equipment was first brought into Illinois for use.

3. Whether taxpayers are entitled, under 35 ILCS 105/3-55, to a credit against Illinois Use Tax liabilities for Ohio Personal Property tax imposed on the use in Ohio of the equipment at issue.

4. Whether the taxpayers are subject to Illinois Use Tax on rental equipment which was placed in use by the taxpayers more than 90 days before such equipment was first brought into Illinois.

The Department filed a brief in support of its position, the taxpayers filed a response and the Department filed a reply brief. The briefs addressed the first three issues listed above, but not the fourth.

Following the submission of all evidence and a review of the record, it is recommended that this matter be resolved in favor of the Department on all four issues.

Findings of Fact:

1. The Department's *prima facie* case against TAXPAYER, including all jurisdictional elements, was established by the admission into evidence of the Correction of Returns, showing tax due of $633,773, penalty of $180,934 and interest of $467,146 for a total

liability due and owing in the amount of $1,281,853. (Dept. Grp. Ex. No. 1; Stip. Grp. Ex. G).

2. The Department's prima *facie case* against TAXPAYER, including all jurisdictional elements, was established by the admission into evidence of the Correction of Returns, showing tax due of $36,408, penalty of $10,923 and interest of $17,227 for a total liability due and owing in the amount of $64,558. (Dept. Grp. Ex. No. 1; Stip. Grp. Ex. I).

3. An administrative hearing was held in this matter on December 12, 1995, after which the parties entered into a Joint Stipulation of Facts ("Stip.") filed on April 5, 1996.

4. TAXPAYER ("TAXPAYER") is headquartered in Independence, Ohio. (Stip. ¶ 2).

5. TAXPAYER ("TAXPAYER") is a wholly owned subsidiary of TAXPAYER and is headquartered in Milwaukee, Wisconsin. (Stip. ¶ 2).

6. Each taxpayer is engaged in the business of leasing construction equipment. (Stip. ¶ 3).

7. Neither taxpayer has offices or employees in Illinois. (Stip. ¶ 4).

8. Neither taxpayer purchased equipment for use in its leasing business from Illinois retailers (Stip. ¶ 5).

9. Each taxpayer leased equipment to persons in Illinois or to persons who brought the equipment into Illinois for use in Illinois. (Stip. ¶ 6).

10. The Department conducted separate audits of each taxpayer's books and records and determined ROT and Use Tax liabilities for the period beginning July 1, 1981, and ending on June

30, 1990 (in the case of TAXPAYER) and for the period beginning July 1, 1981, and ending on December 31, 1990 (in the case of TAXPAYER). (Stip. ¶ 8).

11. Prior to the commencement of the audits by the Department, neither taxpayer had filed Illinois ROT or Use Tax returns for the audit periods. (Stip. ¶ 9).

12. Before the audits were completed, each taxpayer filed Illinois ROT and Use Tax returns reporting and paying tax liabilities they claimed to be due. (Stip. ¶ 10).

13. In computing the liabilities shown on their returns, taxpayers conceded the liabilities determined by the auditors with respect to sales of equipment and with respect to spare parts used or sold in Illinois during the audit periods. (Stip. ¶ 13).

14. On their returns, taxpayers also conceded that they owed Use Tax on rental equipment brought into Illinois. (Stip. ¶ 14).

15. The Department computed the Use Tax liabilities on the rental equipment brought into Illinois by applying the appropriate tax rate in effect when each piece of equipment was brought into Illinois to the original cost of the equipment minus depreciation from the date the equipment was placed in service through the date the equipment was brought into Illinois. (Stip. ¶ 17).

16. In computing the Use Tax liabilities shown on the tax returns filed during the audit, the taxpayers apportioned the depreciated original cost of each piece of equipment by applying a fraction, the numerator of which was the amount of rent received with respect to that equipment for use in Illinois and the denominator of

which was the total rent received for the equipment. Both rental amounts were calculated to the time of the return. (Stip. ¶ 21).

Conclusions of Law:

On examination of the record established, this taxpayer has failed to demonstrate by the presentation of testimony or through exhibits or argument, evidence sufficient to overcome the Department's *prima facie* case of tax liability under the assessments in question. Accordingly, by such failure, and under the reasoning given below, the determination by the Department that TAXPAYER and TAXPAYER owe the deficiencies shown on the Corrections of Return must stand as a matter of law. In support thereof, the following conclusions are made:

ISSUE # 1

The statute involved in this case is the Illinois Use Tax Act. (35 ILCS 105/1 *et seq*.). That Act imposes a tax upon the privilege of using tangible personal property in this state purchased at retail from a retailer. (35 ILCS 105/3). The tax, which became effective in August, 1955, imposes a tax on the privilege of using in Illinois tangible personal property purchased out of state. It was designed to complement the Retailers' Occupation Tax Act. (35 ILCS 120/1 *et seq*.) The purpose of the Use Tax Act is to prevent avoidance of the retailers' occupation tax by persons buying tangible personal property outside of Illinois for use in Illinois. It also serves the purpose of protecting Illinois retailers from diversion of business out of state to avoid the tax. United Air Lines v. Mahin, 49 Ill.2d 45 (1971).

The word "use" is defined for purposes of the Act as being the exercise of any right or power over the property incident to ownership of the property. (35 ILCS 105/2). In the case of leased property, the owner of the property, not the lessee, is the user of the property. Philco Corporation v. The Department of Revenue, 40 Ill.2d 312 (1968). To avoid multistate taxation, the statute provides an exemption for the use in Illinois of tangible personal property acquired outside Illinois and brought into Illinois to the extent the owner has properly paid a sale or use tax in another state with respect to that property. (35 ILCS 105/3-55).

Taxpayers argue that the Department's calculation of the Use Tax liability for the equipment brought into Illinois violates the Commerce Clause of the United States Constitution (the "Commerce Clause," U.S. Constitution, Art I, Sec. 8, Cl. 3) because, as applied to lessors operating in multiple jurisdictions, it fails to satisfy the fair apportionment and nondiscrimination prongs of the four-part test set forth in Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977).

Under the four-part test set forth in Complete Auto Transit, Inc. v. Brady, *supra*, a tax will withstand scrutiny under the Commerce Clause if it is applied to an activity with substantial nexus in the taxing state, it is fairly apportioned, it does not discriminate against interstate commerce, and it is fairly related to the services provided by the State. Goldberg et al v. Sweet, 488 U.S. 252 (1989).

Taxpayers do not contest that the first and fourth parts of the test are met. They argue, however, that the tax is not fairly apportioned and that it discriminates against interstate commerce.

A tax is not fairly apportioned unless it is both "internally and externally consistent." *Id*. at 260. Because the Illinois tax is structured so that if every State adopted a similar tax, no multiple taxation would result it is internally consistent. Goldberg v. Sweet, 488 U.S. 252, 261 (1989). Taxpayers admit that the tax is internally consistent, but argue that it is not externally consistent because as calculated by the Department on the depreciated cost of the equipment the tax bears no relationship to the level of activity taking place in Illinois. This is basically a fairness argument and taxpayers give an example of an out-of-state lessor leasing a piece of machinery with a use tax base of $100,000 for use in Illinois for one day, receiving rent of $500. The tax at 6.25% would be $6,250 which exceeds the rent by more than 1100%. Their premise is that this demonstrates unfairness.

The taxpayer in Philco raised a similar argument. 40 Ill.2d at 319. In response, the court pointed out that the tax is imposed on the privilege of using in Illinois tangible personal property purchased at retail, that the tax is a nonrecurrent tax, and that once paid, the owner is entitled to use it in Illinois as much or as little as desired. Because the owner chooses not to exercise the privilege as freely as he might does not mean that he has been treated unfairly. *Id*. at 320.

Next, taxpayers argue that the Illinois use tax as calculated by the Department in this case is not externally consistent as required by Goldberg, *supra*, because it is not apportioned based on the ratio of rents received with respect to the equipment while it was in Illinois to the total rent received for the equipment, both calculated through the tax return periods. The Supreme Court declined such an approach in Oklahoma Tax Commission v. Jefferson Lines, Inc., 115 S.Ct. 1331, (1995). There, the court said that a sale of goods is viewed as a discrete event which "does not readily reveal the extent to which completed or anticipated interstate activity affects the value on which a buyer is taxed." *Id.* at 1339. The court went on to say that because the sale of goods is unique, if the tax on the sale is internally consistent then it is externally consistent as well. *Id*. at 1340. Since taxpayers concede that the Illinois Use Tax is internally consistent, it is externally consistent as well, and thus, it satisfies the fair apportionment test prescribed by Complete Auto.

The fault in taxpayer's argument is that it misconstrues the apportionment test prescribed by Complete Auto. Since the Retailers' Occupation Tax and the Use Tax are complementary they must be construed together. The entire scheme of sales and use taxation must be taken into account. To be valid, a use tax must result in equal treatment for in-state and out-of-state taxpayers similarly situated. Halliburton Oil Well Cementing Co. v. Reily, 373 U.S. 64, 70. (1963). The Illinois use tax, in consort with the retailers' occupation tax, treat both in-state and out-of-state taxpayers equally. Both pay tax at the same rate. If the out-of-state taxpayer has paid sales tax to another state, a credit is allowed up to the amount of the Illinois tax. Since the Illinois Use Tax provides a credit against its tax for sales taxes paid to other states with respect to the same property, the Illinois Use Tax is fairly apportioned. D.H. Holmes Co., Ltd. v. McNamara, 486 U.S. 24, 31 (1988); Brown's Furniture, Inc. v. Wagner, 171 Ill. 2d 410, 427 (1996).

The taxpayers further argue that the imposition of the use tax on the unapportioned value of property discriminates against interstate commerce because it makes it extremely difficult for such taxpayers to do business in Illinois on a profitable basis. The taxpayers state in their brief that "[A]lmost every other state imposes sales/use tax only on the rents received by the lessor in exchange for using the property in the state." (Taxpayer's Brief p. 10) This statement is unsupported by citation to the statute of any state. In fact, forty-four of the states that impose sales and use taxes, plus the District of Columbia, permit a credit or exemption for similar taxes paid to other states. Jefferson Lines, *supra*, at 1343. The Illinois Use Tax Act takes this approach by providing that if the out-of-state taxpayer has paid sales tax to another state, a credit is allowed up to the amount of the Illinois tax. In this system of taxation, the state in which the property is purchased, or used first, taxes the purchase and thereafter no other state can apply a sales or use tax to the same transaction except to the extent that the tax imposed by the original taxing state is less than the tax imposed by the succeeding taxing state. *Id*. at 1343. So, too, in Illinois, the Illinois Use Tax, in consort with the Retailers' Occupation Tax, treat both in-state and out-of-state taxpayers equally. Both pay tax at the same rate. Therefore, the use tax is not discriminatory. *Id*. at 1345; <u>Brown's Furniture</u>, *supra*, at 428.

Taxpayers also argue that the decision in <u>American Trucking Associations, Inc. v. Scheiner</u>, 483 U.S. 266 (1987) requires apportionment of the tax base in this case in the ratio of rent earned while the equipment was in Illinois to total rent earned through the tax period. Taxpayers' reliance on that decision is misplaced. That case involved taxes in the nature of licensing taxes imposed on truckers. It did not involve a use tax based on the sale and use of tangible personal property.

The courts view a sale of goods as a discrete event, as noted above, and the Supreme Court has consistently approved sales and use taxes without requiring division of the tax base among several states. Instead, the Supreme Court has held that such taxes measured by the sales price at retail are proper without regard to any activity outside the taxing jurisdiction in the past or that might occur in the future. A tax on the sale or use of tangible personal property is properly measured by the gross sales price for the property. <u>Jefferson Lines</u>, *supra*, at 1339. There is no constitutional requirement that a particular apportionment formula must be used just because it is a possibility, as asserted by the taxpayers in this case. The U.S. Supreme Court has never required that any particular apportionment formula be used. <u>Jefferson Lines</u>, *supra*, at 1343. Taxpayers' next argument is that the Department's reliance on <u>Philco Corp</u>., *supra*, is incorrect because that case was decided prior to the U.S. Supreme Court's decision in <u>Complete Auto</u>, *supra*. The fact that <u>Philco Corp</u>. was decided prior to Complete Auto does not mean that the holding in Philco Corp. is no longer valid, and there are no reported cases that say otherwise. Philco Corp. held that the Illinois Use Tax that is imposed on in-state and out-of-state lessors of tangible personal property alike is valid and non-discriminatory. That is still the law. See Jefferson Lines, *supra*, and D.H. Holmes, *supra*.

Taxpayers also argue that the Department's interpretation of the Use Tax Act violates the uniformity and equal protection clauses of the Illinois Constitution and the equal protection clause of the United States Constitution because its application in this case is different than in another case involving a taxpayer in a situation similar to this one, in which the Department permitted the taxpayer to use an alternative formula to calculate the amount of use tax due. In support of this argument taxpayers refer to PLR 90-370 (June 28, 1990), a private letter ruling which stated that an alternative formula for determining the use tax base for tangible personal property leased from a non-resident lessor for use in Illinois is an apportionment determined by multiplying the cost of the property by a fraction, the numerator of which is the gross receipts from Illinois rentals and the denominator of which is gross receipts from all rentals.

Private letter rulings are issued by the Department in response to specific inquiries from taxpayers. They obligate the Department only with respect to the taxpayer making the inquiry. They are not precedent. 2 Admin. Code ch. I, § 1200.110. Therefore, PLR 90-370 is not relevant to this case. Furthermore, there is no provision in the statute, the regulations or any reported Illinois court decisions that provide or allow an alternative method for determining the use tax base for leased tangible personal property such as is involved in these cases. Under the analysis set forth above, the holding in PLR 90-370 is incorrect and the State is not bound by erroneous private letter rulings issued by the Department's employees. Brown's Furniture, *supra* at 432. Accordingly, the Department's application of the Use Tax Act in these cases does not violate the uniformity and equal protection clauses of the Illinois Constitution or the equal protection clause of the United States Constitution.

Although it is irrelevant to the issue, in the section of the taxpayers' brief that addresses the calculation of the use tax base, taxpayers argue that the six year statute of limitation added to the Act by P.A. 88-660 bars the Department from assessing use tax liabilities against either taxpayer for any period prior to December 31, 1985. (Taxpayers' Brief p. 17) As support for this argument, taxpayers incorrectly quote Section 12 of the Use Tax Act (35 ILCS 105/12) to read as follows: ". . . in the case of a failure to file a return required by this Act no notice of tax liability shall be issued on and after each July 1 and January 1 covering tax due with that return during any month or period more than 6 years before that July 1 or January 1, respectively." (Taxpayers' Brief p. 17) In fact, Section 12, as amended by P.A. 88-660 reads as follows: ". . . except in the case of a failure to file a return required by this Act no notice of tax liability shall be issued on and after each July 1 and January 1 covering tax due with that return during any month or period more than 6 years before that July 1 or January 1, respectively." [emphasis added] Therefore, under the plain language of the statute, because taxpayers did not file returns prior to the audit, the six year statute would not bar assessment in this case for periods prior to December 31, 1985.

In any event, the six year statute was added to Section 12 in 1988 and there is nothing to indicate that the revision was intended to be applied retrospectively. Unless a statutory provision states that it is to be applied retrospectively, it can only be applied prospectively. Jefferson Ice Co. v. Johnson, 139 Ill. App. 3d 626, (1st Dist. 1985). Therefore, the Department's assessments for periods prior to December 31, 1985, are not barred by the statute of limitations.

ISSUE # 2

Taxpayers argue that they are entitled to a credit against Illinois Use tax for sales and use taxes paid to other states subsequent to the date such equipment was first brought into Illinois for use. This argument is totally without merit. Taxpayer has cited no statutory provision, regulation or case law in Illinois or from any other state that allows a credit against use tax imposed on leased property brought into a state for sales or use tax paid to other states after the property is brought into the taxing state. Section 3-55 of the Use Tax Act (35 ILCS 105/3-55) provides a credit against Illinois Use Tax for property acquired outside of Illinois and brought into Illinois by a person who has "already paid a tax in another State in respect to the sale, purchase, or use of that property to the extent of the amount of the tax properly due and paid in the other state." [emphasis added.] The statute does not say "already paid or to be paid" to another state. Such a provision would be fatuous because over a period of years, the owner might lease the asset for use in a number of the 44 states that impose sales and use taxes similar to Illinois law. If such subsequently paid taxes were to be allowed, the states would be inundated with claims for refund over the years as these taxes are paid. It is inconceivable that any court would require such a result.

Taxpayer argues further that failure to allow subsequently paid taxes as a credit violates the fair apportionment requirement of the Complete Auto test because it fails the "external consistency" test. As noted with respect to **ISSUE #1**, the Supreme Court has held that a sales and use tax scheme that is internally consistent, as it is in this case, is externally consistent as well. Jefferson Lines, *supra*, at 1340. As noted previously, the Illinois Use Tax has been held to be fairly apportioned as required by Complete Auto. Brown's Furniture, *supra*, at 427.

ISSUE # 3

The taxpayers argue that Ohio personal property taxes paid by taxpayers ought to be allowed as a credit against the taxpayers' Illinois Use Tax assessment. They cite no statutory provisions, regulations or case law from Illinois or any other state to support this theory. The Illinois statute provides for a credit for a sale or use tax already paid in another state "in respect to the sale, purchase, or use of that property, . . .". It does not allow a credit for personal property taxes. As noted previously, the Illinois Use Tax is a non-recurrent tax imposed on the privilege of using tangible personal property in Illinois. The Ohio personal property tax is an *ad valorem* recurring tax imposed annually on the depreciated book value of tangible personal property owned in the State of Ohio. (Ohio Rev. Code §§ 5709.1, 5711.02, 5711.18) It is not a tax in respect to the sale or use of that property. It is, therefore, not creditable against the Illinois Use Tax assessed on taxpayers' property which is leased and used by the lessee in Illinois.

ISSUE # 4

On the Use Tax returns which taxpayers filed during the course of the audit, they claimed an exemption for each piece of equipment that had been in use for more than 90 days before being brought into Illinois. The Department disallowed this exemption. Taxpayers cite no statutory or other authority for such an exemption, and, indeed, there is none. Therefore, taxpayers are not entitled to an exemption for equipment in use for more than 90 days before it was brought into Illinois.

WHEREFORE, for the reasons stated above, it is my recommendation that the Department's assessment be upheld in full.

Date

Charles E. McClellan
Administrative Law Judge